V Leeladhar: Demystifying Basel II

Special address by Mr V Leeladhar, Deputy Governor of the Reserve Bank of India, at the FICCI-IBA Conference on "Global Banking: Paradigm Shift", Mumbai, 26 September 2006.

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Friends, it gives me great pleasure to share my thoughts on some of the elements of Basel II implementation in India with this august gathering. I firmly believe that periodical sharing of thoughts and views by us on issues of topical relevance with bankers - both domestic and foreign; eminent bank regulators and supervisors from abroad; and above all - the users of the banking system, is fundamental for promoting greater transparency and understanding of the intent and purposes of various regulatory initiatives. I, therefore, would like to thank the organizers for giving me this wonderful opportunity to take this process forward.

Reserve Bank's association with the Basel Committee on Banking Supervision (BCBS) – the owner of the Basel II framework - dates back to 1997 as India was among the 16 non-member countries that were consulted in the drafting of the Basel Core Principles. Reserve Bank of India became a member of the Core Principles Liaison Group in 1998 and subsequently became a member of the Core Principles Working Group on Capital. Within the Working Group, RBI has been actively participating in the deliberations on the Basel II framework and had the privilege to lead a group of six major non-G-10 supervisors which presented a proposal on a simplified approach for Basel II to the Committee.

The subject matter for our discussion today is "Demystifying Basel II". All of you will agree that we would be able to demystify something which is a mystery in the first place. I am not sure how many will agree that Basel II is a mystery. Since I personally believe that Basel II is not a mystery, my assignment becomes more challenging. At the outset we may agree that while Basel II - as a framework - might not be a mystery, some elements of the framework might be a mystery for some people. I, therefore, propose to deal with certain specific elements of the Basel II framework, which has been a challenge to us - and we might not be alone in that respect. I believe a better understanding of the relevant perspectives among banks, regulators, users of the banking system and other market players would be useful for an effective and meaningful implementation of Basel II.

Approach to reforms

With the commencement of the banking sector reforms in the early 1990s, the RBI has been consistently upgrading the Indian banking sector by adopting international best practices. The approach to reforms is one of having clarity about the destination, deciding on the sequence and modulating the pace of reforms to suit Indian conditions. This has helped us in moving ahead with the reforms in a purposeful but non-disruptive manner.

Basel I

I would like to briefly mention the progress made by the Indian banking system with regard to Basel I implementation before we discuss Basel II implementation. Adopting our general approach of gradualism, we implemented the Basel I framework with effect from 1992-93 which was, however, spread over 3 years – banks with branches abroad were required to comply fully by end March 1994 and the other banks were required to comply by end March 1996. Further, India responded to the 1996 amendment to the Basel I framework which required banks to maintain capital for market risk exposures, by initially prescribing various surrogate capital charges for these risks between 2000 and 2002. These were replaced with the capital charges as required under the Basel I framework in June 2004, which become fully effective from March 2005. With the successful implementation of banking sector reforms over the past decade, the Indian banking system has shown substantial improvement on various parameters. It has become robust and displayed significant resilience to shocks. There is ample evidence of the capacity of the Indian banking system to migrate smoothly to Basel II norms.

Why Basel II?

I now propose to discuss a fundamental issue which has been raised and addressed in the context of Basel II implementation not only in India but elsewhere – *"Why implement Basel II?"* Many of us who are from the financial sector are aware of the main incentives for adoption of Basel II. These are

- it is more risk sensitive;
- it recognizes developments in risk measurement and risk management techniques employed in the banking sector and accommodates them within the framework;
- it aligns regulatory capital closer to economic capital.

These elements of Basel II take the regulatory framework closer to the business models employed in banks. Further, the Basel I framework can be seen as a "one size fits all" model which measures risk broadly and it is necessary for the regulator to discriminate among banks on the basis of their risk profiles. While these reasons are generally available from the vast amount of literature available in public domain, I would like to share with you how the Reserve Bank views the Basel II framework and this may also be the perspective which other regulators might share.

In India, we have 88 commercial banks, which account for about 82% (total assets) of the financial sector; over 2000 cooperative banks, which account for about 5%; and 133 Regional Rural Banks, which account for about 3%. The policy approach to Basel II in India is such that external perception about India conforming to best international standards remains positive. Taking into account the size, complexity of operations, relevance to the financial sector, need to ensure greater financial inclusion and the need for having an efficient delivery mechanism, the capital adequacy norms applicable to these entities have been maintained at varying levels of stringency. On the *first track*, the commercial banks in India will start implementing Basel II with effect from March 31, 2007. They will initially adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk. After adequate skills are developed, both by the banks and also by the supervisors, some banks may be allowed to migrate to the Internal Rating Based (IRBA) Approach and Advanced Measurement Approach (AMA). The cooperative banks, on the *second track*, are required to maintain capital for credit risk as per Basel I framework and through surrogates for market risk; the Regional Rural Banks, on the *third track*, have a minimum capital requirement which is, however, not on par with the Basel I framework. Consequently, we will have a major segment of systemic importance on a Basel II framework, a portion of the minor segment partly on Basel I framework, and the smallest segment on a non-Basel framework. One might say that we are adopting a three-track approach with regard to capital adequacy rules. Further, we are approaching Basel II as a means to achieve an end – the goal being vastly improved risk management systems in the Indian banking sector. Even though the commercial banks will be adopting the simpler options available under the Basel II framework, the supervisory focus will be primarily on enhancing the quality of risk management systems in these banks.

Notwithstanding the above, in contrast to Basel I, the revised framework is highly complex and makes its understanding and implementation a great challenge to not only the regulatory community but also to the regulated community. Much of the complexity stems from the variety of available options, the likely impact of diversity in exercise of national discretions, lack of clarity on regulatory approach to various implementation issues - especially in a cross border situation and the likely unintended scope for regulatory arbitrage. In addition to the complexity of Basel II, there have been other issues which have been raised at various fora suggesting that the revised framework, as designed, is likely to pose other threats/ challenges to some economies. Some of these issues are *procyclicality, herding behaviour, likely adverse impact on emerging market economies.*

Basel II challenges

I would now like to discuss some of the challenges which we have faced in our journey to Basel II implementation and how we have attempted to address these challenges. I am sure the regulators in other jurisdictions would also have faced similar issues and they would have devised their own strategies for addressing them. As a part of the consultative process and with a view to ensuring smooth migration to the new framework, we have constituted a 'Steering Committee' comprising of representatives from fourteen select private sector banks, public sector banks and foreign banks, the Indian Banks' Association and the Reserve Bank of India. The Steering Committee has examined various issues of the Basel II framework and made its recommendations to the Reserve Bank for

consideration. Hence, we might say that the banks and the Reserve Bank have worked together to address the challenges. Some of these are discussed below:

a) Which level / approach?

When Basel II framework was being finalized and even soon after its finalization the general indications were that many banks in major jurisdictions would aim at implementing Internal Ratings Based Approach (IRBA) for credit risk and Advanced Measurement Approach (AMA) for operational risk straightaway. It would be seen that the main incentive for this stance might have been that adoption of IRBA / AMA would reduce the capital requirements for banks and thus, enable them to achieve better capital efficiency. This stance of the banks / regulators in other jurisdictions seemed to put some pressure on banks in India also to adopt IRBA / AMA directly. There were some thoughts in some quarters that if the banks in India do not adopt IRBA / AMA, they run the risk of being viewed as inferior banks and consequently the system might be branded as a secondary citizen in the global financial markets. As mentioned earlier, our approach to reforms has been to align with the international best practices but adopt them in a manner and pace as suitable to our economy and environment. Therefore, we have consciously decided to mandate the Standardized Approach and Basic Indicator Approach to all scheduled commercial banks in India as the first step in migration to Basel II. We also observe that as compared to the initial indication, the number of international banks which are looking to directly adopt IRBA / AMA at the first instance has reduced. Many jurisdictions require only a few banks to adopt IRBA / AMA while all the other banks would be on the simpler approaches. We observe that our approach to Basel II implementation has been widely appreciated and there is a general element of caution advocated while allowing banks to adopt the IRBA / AMA.

b) External ratings

Since our banks are required to adopt Standardised Approach for credit risk, it is incumbent upon the Reserve Bank to accredit the external rating agencies whose ratings the banks may rely upon for capital adequacy purposes. In India, we have 5 domestic agencies – the oldest commenced ratings in 1987 and youngest one was established last year. We are confronted with a situation where it is likely that only about 10% of banks' corporate exposures are rated by these external rating agencies. One might, therefore conclude that the banks in India would be effectively applying the Basel I risk-weight (viz. 100 per cent) for most of their corporate exposures even after adopting Basel II. This may be seen as a major disincentive for banks to migrate to Basel II. Our interactions with the domestic rating agencies indicate that they are equipped to scale their resources, in case of need, to cater to a higher demand for ratings consequent upon implementation of Basel II. At present, the ratings in India are issue specific and not issuer specific. The rating agencies are also putting in place methodologies for undertaking issuer ratings, if required by the market. Hence it is expected that, with the implementation of Basel II in India, the proportion of rated entities is likely to increase over a period – providing the appropriate basis for risk discrimination in the system.

In the light of the level of rating penetration at present, one of the suggestions was that until a significant proportion of corporate exposure of banks is covered by external ratings, banks may be allowed to use their internal ratings in respect of those exposures which do not have an external rating. While the intent behind the suggestion is clear, it would be necessary to appreciate that banks would have to go through a rigorous process under the Basel II framework before they are allowed to use their internal ratings for capital adequacy purposes. Further, the Basel II framework does not envisage the use of internal ratings to supplement the external ratings under the standardised approach. Hence, the suggestion was not accommodated.

Another issue which keeps coming up at various fora is the issue of assigning a lower risk-weight of 100 per cent for unrated entities and higher risk-weight of 150 per cent for entities rated below "BB(-)", thereby providing the corporates a perverse incentive to remain unrated. Since it might not be fair to assume up-front that all unrated entities are high risk entities, we have decided to presently adopt the 100 per cent risk weight for unrated exposures – as prescribed in the Basel II framework. However, we propose to review the health of unrated exposures in banks through the pillar II process as well as the other onsite and offsite feedback mechanisms and revise the risk-weights for unrated exposures, if warranted.

The domestic rating agencies are also placed in a unique situation, which impacts their default statistics. Two significant factors in this regard are: (a) they have a small base of rated entities and (b) they lack the geographical diversification benefits which the international rating entities enjoy.

Interaction with the rating agencies have indicated that the processes and methodologies adopted by them were generally in alignment with those of the international rating agencies and despite the above two constraining factors their default statistics may not be out of sync with the Basel trigger ratios.

c) National discretion

The Basel II framework offers the national supervisors an element of discretion in several areas to enable them to adopt the framework to suit their respective banking systems. It is likely that the discretion available under the framework might induce apprehension / expectation in some quarters that national supervisors might adopt the most lenient options – thus diluting the rigour of the Basel II framework. In India, we have adopted an objective approach while deciding on the items of national discretion. Consequently, we have taken a conservative view on certain areas of national discretion. Some of the areas where the discretion exercised by us is on a more conservative level are:

- State Government guaranteed exposures attract a higher risk weight of 20 per cent, though the framework allows a zero per cent risk weight.
- Exposures to public sector enterprises are treated on par with corporate exposures though the framework allows them to be treated on par with bank or sovereign exposures.
- While, under option 1, we have discretion to apply 20% risk weight for exposures to all banks we have decided to extend this concessionary risk-weight only to exposures to scheduled banks. Exposures to non-scheduled banks will be treated separately and assigned a risk-weight of 100%.
- Though the Basel II framework allows lower risk-weight of 35% for residential mortgage and 75% for personal loans (as part of retail) we have opted to assign a higher risk-weight of 75% for residential mortgage and 125% for personal loans.

These are hard decisions which we, as a regulator, have taken with a view to capturing the true level of underlying risk knowing fully well that this might cast a burden on the banks in India.

d) Internal capital adequacy assessment process

The internal capital adequacy assessment process which forms an important element of Pillar II is an integral and important part of the Basel II framework. Yet, some doubts are being raised with regard to its relevance for banks adopting Standardised Approach and Basic Indicator Approach. I would like to mention here that though Pillar II is not a formal part of Basel I framework, the Reserve Bank has been discharging some of the Pillar II responsibilities even under the current framework. The Basel II framework takes this a step forward by making it a formal requirement. The additional element which casts some formal responsibility on the banks under the new framework is that banks are required to put in place an effective internal capital adequacy assessment process (ICAAP) which should not only address the 3 major risks (viz. credit risk, market risk, and operational risk) but also other risks for which explicit capital has not been prescribed under Pillar I. Further, banks are also required to address suitably other dimensions of the three Pillar I risks. A professionally managed bank would suo moto strive to plan for and achieve most efficient use of capital even if there were no formal regulatory requirement. The ICAAP merely attempts to formalise these efforts of bank managements as a part of the capital adequacy framework. I am sure this would clarify the relevance of including ICAAP as an integral part of Pillar II.

e) Stress testing

Stress testing has become an integral part of banks' risk management systems and is used to evaluate their potential vulnerability to certain unlikely but plausible events or movements in financial variables. The supervisory review process under Pillar 2 of Basel II framework is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. Banks must demonstrate, under the internal capital adequacy assessment process prescribed by Pillar 2, that they have enough capital to not only meet the minimum capital requirements but also to withstand a range of severe but plausible shocks. In the above background, the need for banks in India to adopt 'stress tests' as a risk management tool has been emphasised in the Annual Policy Statement announced by the Governor in April 2006. The draft guidelines in this regard were issued and the same are under finalisation on the basis of the feedback received from

market participants. I would therefore urge banks to approach stress testing as an integral part of the Basel II framework.

f) Data requirements

The general reaction is that '*Basel II is data intensive and paucity of acceptable data is a challenge to meaningful Basel II implementation".* As I understand, the data requirements for banks implementing Standardised Approach and Basic Indicator Approach under Basel II are not very significant. It is largely similar to the data captured under Basel I. However, banks need to capture more granular details of their credit risk exposures to enable them to assess the capital requirements accurately. This places a demand on their MIS, which might require a certain degree of fine tuning, to capture exposure-wise details of (i) credit risk mitigants, (ii) availability of external ratings, (iii) specific provisions held in the case of non performing assets etc. Many banks have attempted to achieve this by opting for core banking solutions while others have attempted to achieve this through a better reporting framework.

g) Operational risk

The capital charge prescribed for operational risk under the Basic Indicator Approach – viz. 15 per cent of the average gross income for the preceding three years – is considered by some as too high, especially because most of the commercial banks are simple traditional banking entities. In some quarters the 15 per cent norm is considered to be relevant only for sophisticated, complex, tech-savvy global banks in developed economies. Another point put across in support of this argument is that the loss on account of frauds in banks in India is only a fraction of the capital requirement specified for banks adopting BIA, which is seen to be in the range of 1 to 5 percent of the gross income. Therefore, Basel II is considered as a burden on banks. Here, I would like to mention that it would be inappropriate to assume that (a) operational risk losses manifest only in tech-savvy and complex banks and (b) that in other banks it manifests only as frauds. Operational risks are assumed by all banks and further operational risk losses manifest in other forms, which banks ought to reckon to have a wholesome picture of their exposure to operational risk. I would, therefore, urge banks to put in place sound and efficient operational risk management framework since this will be a focus under the Pillar 2 framework. Further, we would encourage banks to compile comprehensive operational loss data – over a period – to enable them to establish beyond doubt the actual level of their operational risk losses.

Conclusion

As I mentioned earlier, "flexibility" has been the hallmark of our reform process, which was evident in our Basel I implementation. Taking into account the concerns that may arise during the course of Basel II implementation, it may be necessary for us regulators, especially in the emerging economies, to adopt a flexible approach while implementing Basel II.

As I mentioned at the outset, I had set out to demystify something which I thought was not a mystery in the first place. I have tried to share some of my thoughts on certain elements of the Basel II framework – as we have approached them in our implementation efforts. I am sure this exchange of thoughts and views would have added greater clarity to our implementation efforts and placed some of the important elements of Basel II in the right perspective.

While, I have focused to a large extent on the challenges that we, as a system, face in the implementation of Basel II, I would like to balance this with the thought that Basel II does not pose just challenges, it also offers considerable opportunities to banks to upgrade their risk management systems and thus become more efficient and competitive.

Thank you.